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## WHO OWNS A CLASS ACTION?

RICHARD A. BOOTH\*

Is the plaintiff in a class action the master of his complaint? That is the question now before the Supreme Court. In *Standard Fire Insurance Co. v. Knowles*,<sup>1</sup> the respondent suffered hail damage to his house.<sup>2</sup> His insurance company paid for the cost of repairs but not for the standard twenty percent markup charged by his contractor. Knowles sued in state court—one known to be friendly to class actions—for himself and for similarly situated Arkansas homeowners.<sup>3</sup> But to avoid being removed to federal court under the Class Action Fairness Act of 2005, Knowles limited the damages he sought to less than \$5 million by defining the class to include only homeowners who had similar claims arising in the previous two years—even though the statute of limitations permitted claims as old as five years.<sup>4</sup>

Although the ultimate question in *Knowles* is whether the plaintiff class may be gerrymandered so as to avoid removal to federal court, a closely related question may arise in securities fraud class actions (which are filed in federal court in the first place). In an action under SEC Rule 10b-5, the plaintiff typically seeks to recover for losses suffered as a result of buying a stock at a price inflated by management misrepresentations. In such a case, the measure of damages is the difference between the price paid and the price at which the stock settles after corrective disclosure.<sup>5</sup>

Although this remedy is well-established, it is fundamentally flawed in that it includes losses suffered by the corporation itself that should be the subject of a derivative action.<sup>6</sup> Specifically, the decrease in price may come from several different sources: (1) lower expected return, (2) an increase in the cost of capital, or (3) enforcement and litigation expenses.<sup>7</sup> An increase in the cost of capital may or may not be actionable, depending on whether it comes from (a) increased firm-specific business risk, (b) increased industry risk, or (c) a loss of trust in management (reputational loss).<sup>8</sup> The portion of the loss that comes

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1. 133 S. Ct. 90 (2012).

2. See *Knowles v. Standard Fire Ins. Co.*, No. 4:11-CV-04044, 2011 WL 6013024, at \*1 (W.D. Ark. 2011 Dec. 2, 2011), *cert. granted*, 133 S. Ct. 90 (2012).

3. See *id.* at \*2.

4. See Class Action Fairness Act of 2005, 28 U.S.C. § 1332(d) (2006).

5. See, e.g., *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2186 (2011) (discussing distinction between transaction causation, or price impact, and loss causation).

6. See Richard A. Booth, *Index Funds and Securities Fraud Litigation*, 64 S.C. L. REV. 265 (2012).

7. See *id.* at 272.

8. See *id.*; see also Barbara Black, *Reputational Damages in Securities Litigation*, 35 J. CORP. L. 169 (2009). But see Allen Ferrell & Atanu Saha, *The Loss Causation Requirement for Rule 10b-5 Causes-of-Action: The Implications of Dura Pharmaceuticals, Inc. v. Broudo*, 63 BUS. LAW. 163 (2007); Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7, 29–30 (1994).

from items (3) and (c) are clearly derivative in nature and affect all stockholders, including both buyers and holders.<sup>9</sup> But in a Rule 10b-5 class action only buyers have standing to sue.<sup>10</sup> Moreover, because the corporation ultimately pays any settlement in a class action, portfolio investors—such as mutual funds—who may have bought some shares during the fraud period but who hold even more shares that were purchased before the fraud period, often lose more as a result of settlement than they recover in the class action.<sup>11</sup> These investors would, or should, prefer a derivative action in which the corporation recovers from the individual wrongdoers.<sup>12</sup>

The Federal Rules of Civil Procedure seek to protect absent class members by requiring the court to certify that an action is appropriate for class action status before it may proceed as such.<sup>13</sup> Among other things, the court must find that the plaintiff is an adequate representative for the class and, in cases seeking damages for individual class members, that a class action is superior to other ways of litigating the case.<sup>14</sup>

Clearly, an undiversified stock-picking investor cannot be an adequate representative for diversified portfolio investors who would prefer that the action be dropped altogether. The Supreme Court decided that issue in 1940 in *Hansberry v. Lee*<sup>15</sup> where the plaintiff homeowner sought a declaration as to the validity of a racially restrictive covenant over the objection of a would-be seller.<sup>16</sup> Neither does it help for objecting investors to opt out since by doing so they will forgo their share of the remedy but will still be taxed, in effect, as holders for the benefit of buyers.

The courts should decline to certify most Rule 10b-5 actions as class actions because the plaintiff class invariably includes diversified portfolio investors—buyer-holders, who will lose more on the shares they hold because of the class action itself than they will gain on the shares they bought during the fraud period.<sup>17</sup> Moreover, such investors are quite indifferent to a class action remedy anyway because over time they are just as likely to sell a fraud-affected stock as to buy one.<sup>18</sup> But *Knowles* suggests that a plaintiff can define the class so as to exclude investors who might object. To be sure, it is not clear how a

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(arguing that there should be no recovery for consequential damages in connection with securities fraud claims).

9. See Booth, *supra* note 6, at 273–74.

10. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731–32 (1975); see also *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 82–85 (2006) (construing Standard Litigation Uniform Standards Act connection requirement independently of judicially imposed standing requirement).

11. See Booth, *supra* note 6, at 287–91.

12. See *id.* at 294–95.

13. See FED. R. CIV. P. 23(c).

14. See FED. R. CIV. P. 23(a), (b)(3).

15. 311 U.S. 32 (1940).

16. See *id.* at 37–39.

17. See Booth, *supra* note 6, at 303–05.

18. See Richard A. Booth, *Class Conflict in Securities Fraud Litigation*, 14 U. PA. J. BUS. L. 701, 702 (2012).

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court could ascertain precisely who is a member of a class so defined, which would preclude certification.<sup>19</sup> But even if it is possible to determine who belongs in the class, the question remains whether it is permissible to gerrymander the class in order for the action to be certified as a class action.

To be sure, the courts have held that the plaintiff is the master of his complaint.<sup>20</sup> But there are limits to this metaphor, which emanates from a 1938 case that did not involve a class claim. In contrast, a class plaintiff cannot drop the case or settle it without the approval of the court.<sup>21</sup> Moreover, the attorney for the plaintiff class is paid out of the recovery pot if the case succeeds—but only to the extent that the court deems fair.<sup>22</sup> And in a securities fraud class action, the court must determine who should serve as the lead plaintiff under the Private Securities Litigation Reform Act of 1995 (“PSLRA”).<sup>23</sup> Clearly, absent class members have rights.

In a case like *Knowles*, an excluded class member can always start his own class action—assuming that he knows he has been excluded. But what if the first action bankrupts the defendant or the class is defined so as to deplete available insurance and to split the pot among the fewest possible claimants? And whatever happened to judicial economy? Although litigants are generally free to frame their claims however they want, they are not free to hog the judiciary to the exclusion of others. There is a public interest inherent in the use of the judicial system. If there are multiple claims that are essentially identical, the courts have the power to consolidate them in the interest of resolving as many disputes as possible.<sup>24</sup> Indeed, the Securities Litigation Uniform Standards Act of 1998 effectively requires the consolidation of related actions involving fifty or more plaintiffs.<sup>25</sup>

Moreover, in a securities fraud class action that subsumes derivative claims—as any meritorious action does—the plaintiff is a fiduciary for his fellow stockholders.<sup>26</sup> He cannot convert a derivative claim into a class claim simply because he would like to recover individually rather than for the corporation—let alone gerrymander the class to exclude inconvenient class

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19. See *In re Initial Pub. Offering Sec. Litig.*, 471 F.3d 24, 29 (2d Cir. 2006) (noting that Supreme Court has been silent on what showing plaintiffs must make in support of motion for class certification).

20. See *St. Paul Mercury Indem. Co. v. Red Cab Co.*, 303 U.S. 283, 294 (1938) (“If [a plaintiff] does not desire to try his case in the federal court, he may resort to the expedient of suing for less than the jurisdictional amount, and though he would be justly entitled to more, the defendant cannot remove.”).

21. See FED. R. CIV. P. 23(e); see also *Zapata Corp. v. Maldonado*, 430 A.2d 779, 787–88 (Del. 1981) (holding court retains power to approve or disapprove settlement or dismissal of derivative action).

22. See FED. R. CIV. P. 23(h).

23. See Securities Exchange Act of 1934, 15 U.S.C. § 78u-4 (2006); see also FED. R. CIV. P. 23(g) (certifying court must appoint class counsel).

24. See FED. R. CIV. P. 42.

25. See Securities Exchange Act of 1934, 15 U.S.C. § 78u-4.

26. See, e.g., *Heckmann v. Ahmanson*, 214 Cal. Rptr. 177, 186–88 (Ct. App. 1985).

members.<sup>27</sup> As the late Judge Robert Bork observed in *Cowin v. Bresler*,<sup>28</sup> to permit individual recovery on such claims is to divert an asset of the corporation to the plaintiff stockholder to the exclusion of other stockholders.<sup>29</sup> The principle applies *a fortiori* where the class claim would be paid by the corporation as in a securities fraud class action. In any event, it is for the court—not the plaintiff—to decide whether a claim is direct or derivative.<sup>30</sup>

Ironically, a derivative action is a type of class action. It is a class action by the stockholders who seek an injunction compelling the corporation to sue those who have done it wrong—so to speak—usually the directors and officers.<sup>31</sup> Because the rules require that a class claim for damages be superior to other means of resolving the dispute, it would seem that the rules require that if a claim can be handled as a derivative action, it must be so handled.<sup>32</sup>

To be clear, the approach advocated here would likely mean the end of the securities fraud class action as we know it.<sup>33</sup> But that would be a good thing.<sup>34</sup> Most legal scholars agree that class actions do little to compensate investors. Since the defendant company (or its insurer) pays, the remedy is ultimately circular—holders pay buyers. But most seem also to agree that class actions are an important source of deterrence.<sup>35</sup> As for compensation, diversified investors need no compensation for trading losses. Because a diversified investor is

27. See *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004).

28. 741 F.2d 410 (D.C. Cir. 1984).

29. See *id.* at 414; see also *Smith v. Waste Mgmt., Inc.*, 407 F.3d 381 (5th Cir. 2005); cf. *Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R. Co.*, 417 U.S. 703, 712–13 (1974).

30. Incidentally, it has become common for large stockholders to opt out of securities fraud class actions to pursue their claims individually, possibly to avoid the special requirements imposed by PSLRA or (more likely) to negotiate for a more generous settlement that need not be shared with the class. Cf. *Conn. Ret. Plans & Trust Funds v. Amgen, Inc.*, 660 F.3d 1170, 1175 (9th Cir. 2011), *cert. granted*, 132 S. Ct. 2742 (2012) (representing that plaintiff would pursue its claim individually if class is not certified). Although some have suggested that this demonstrates the good faith of securities fraud plaintiffs and indeed the need for a remedy, the argument here shows that such tactics are more properly viewed as abusive. Once it is recognized that the genuine harm to investors is derivative rather than direct, presumably the courts will have no problem dealing with individual claims appropriately.

31. See *Ross v. Bernhard*, 396 U.S. 531, 541–42 (1970).

32. Cf. *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2565–66 (2011).

33. See Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L.J. 1 (2007). Thanks to REM.

34. Thanks to Martha Stewart.

35. See, e.g., William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 103–118 (2011); Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297 (2009); Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237 (2009); Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301 (2008); see also John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534 (2006); Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 336–38 (2009).

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equally likely to sell an overvalued stock as to buy one, such losses come out in the wash. The only genuine losses—from the cost of litigation and increases in the cost of capital—are derivative losses suffered by all of the stockholders. Thus, securities fraud class actions constitute excessive deterrence in that they offer a windfall to investors, who are thus induced to sue too often. Although one might argue that there is no such thing as over-deterrence when it comes to fraud, the downside is that managers are reluctant to speak as freely as they might otherwise do and that investors are left with less information than they might otherwise enjoy. Moreover, fraud is a bit of a misnomer in the typical Rule 10b-5 class action, because neither the corporation nor the individual defendants, if any, gain from the offense. In contrast, a derivative action is perfectly tailored to the genuine harm from securities fraud. And a derivative action is a more potent deterrent in that the individual wrongdoers pay.

In short, there is much more at stake in *Knowles* than may appear at first blush. And judging by the number of class action cases it has taken recently, the Court seems to be particularly keen on making sense out of the law relating thereto. *Knowles* is an ideal opportunity for the Court to make it clear that a class action is a matter of judicial grace, and that as such, the courts have the power and the duty to assure that the device is used efficiently and equitably.